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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. ~~986~~ 119

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

NEIL SULLIVAN AND GRACE SULLIVAN.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

JAMES ROSS AND ANN ROSS.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

SAM MESI.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENTS IN OPPOSITION.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956.

No. 983.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

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NEIL SULLIVAN AND GRACE SULLIVAN.

COMMISSIONER OF INTERNAL REVENUE,
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SAM MESI.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR RESPONDENTS IN OPPOSITION.

Respondents present this collective brief in opposition to the single petition filed to review the judgments below. The petition adequately states the Opinions Below, Jurisdiction and Statutes Involved.

QUESTION PRESENTED

Respondents conducted bookmaking businesses in Illinois, a state in which such activity is unlawful. In the operation of such businesses they made payments for the rental of the premises within which such businesses were conducted and for the wages of their employees.

The question is whether the expenses of rent and wages, specifically allowable as deductions in computing net income under the provisions of Sections 23 (a) (1) (A) of the Internal Revenue Code of 1939, are nonetheless not deductible because the trade or business within which they were incurred was illegal under the provisions of the law of the state within which the business was conducted.

STATEMENT

Except for the noted exceptions, the Statement in the petition is adequate. The exceptions are:

The conclusion relating to the *Ross* and *Sullivan* cases that "The payment of the wages and rent constituted a violation of Section 582 of the [Illinois Criminal] Code." (Pet. 7);

The conclusion relating to the *Mesi* case that "the payment of the wages, in and of itself, constituted an illegal act." (Pet. 8.)

No cited Illinois statute makes illegal the payment of rent and wages. This issue will be discussed in the following section of this brief.

The Statement also fails to point out that the decision of the Tax Court, in the *Mesi* case, was by a divided court, and that Judges Murdock, Tietjens and Atkins dissented. 25 T. C. 513.

REASONS FOR NOT GRANTING THE WRIT.

Perhaps the general question of the deductibility of expenses under Section 23(a) of the 1939 Internal Revenue Code (Section 162 (a) of the 1954 Code) which are in conflict with "public policy" is one which might well be clarified by this Court. But that question is not presented by these cases. These cases involve expenses for rent and salaries which are specifically enumerated in the statute as being included within the statutory expression "ordinary and necessary". Congress has on many occasions acknowledged that gambling, whether legal or illegal in the state where carried on, is a trade or business; and has also clearly indicated that expenses incurred in such pursuit are deductible on the same basis as the expenses of any other business.

Thus since the statute is clear there is no room for the application of any other "public policy" including that of a state, as expressed in its statutes, since the federal policy as expressed in the tax statute and by Congressional intent is certainly paramount. "Here we are concerned only with the meaning and application of a statute enacted by Congress, in the exercise of its plenary power under the constitution, to tax income. The exertion of that power is not subject to state control. It is the will of Congress which controls * * *" *Burnet* v. *Harmel*, 287 U. S. 103, 110 (1932).

Prior Supreme Court Decisions. The teaching of the prior decisions of this Court concerning the relationship between Section 23(a) and "public policy" is plain; only where the Congressional intent is not clear may a general policy be applied to interpret the statute. Thus in *Textile Mills Security Corp.* v. *Commissioner*, 314 U. S. 326 (1941), the Court stated, in upholding the disallowance as deductions under Section 23(a) of payments for lobbying and propaganda to procure passage of legislation permitting

the recovery of properties seized during World War I under the Trading With the Enemy Act:

> "Contracts to spread such insidious influences through legislative halls have long been condemned * * * Whether the precise arrangement here in question would violate the rule of those cases is not material. The point is that the general policy indicated by those cases need not be disregarded by the rule-making authority in its segregation of non-deductible expenses. There is no reason why, *in absence of clear Congressional action to the contrary*, the rule-making authority cannot employ that general policy in drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction. The exclusion of the latter from 'ordinary and necessary' expenses *does no violence to* the statutory language." 314 U. S. 326, 338-339. (Emphasis added.)

Neither *Lilly* v. *Commissioner*, 343 U. S. 90 (1952) nor *Commissioner* v. *Heininger*, 320 U. S. 467 (1943)—the two other decisions relating to public policy and Section 23(a)—is inconsistent with the holding in *Textile* that Congressional intent is paramount, and only in the absence of clear Congressional action to the contrary may a general policy be applied in determining deductibility of expenses. "Our enquiry is therefore limited to the narrow issue of whether these expenses were 'ordinary and necessary' within the meaning of Section 23(a)," said the Court in *Heininger*, 320 U. S. 467, 470. And in *Lilly* the Court again framed the issue as being one involving the interpretation of Section 23(a). "In such a case [where the expenses violated or were incidental to violation of state or federal law] it could be argued that the outlawed expenditures, by virtue of their illegality, were not 'ordinary and necessary' business expenses within the meaning of § 23(a)(1)(A)." 343 U. S. 90, 94-95. Here again, the meaning of the statute is paramount.

It is because Section 23(a) did not clearly permit the deduction of expenditures for bribes, penalties, fines, lobbying, defense of fraud charges, or "kickbacks" to opticians by eye glass manufacturers that courts have permitted consideration of the "public policy" issue when such deductions were questioned. Some of these expenditures were allowed; others were not. But these decisions do not evidence any conflict with the decisions of the Court of Appeals in the present cases, for these are areas where there has been no "clear Congressional action to the contrary," in the words of *Textile*. These "public policy" decisions do not establish the proposition that the deductibility of an expenditure is solely dependent on policy considerations no matter what the statute provides, but rather that only if the statute does not plainly cover the deduction may another policy be looked to. "We may grant, if a policy exists, that it may be used to resolve the uncertainty of a law, but it cannot be a substitute for a law." *Fullinwider* v. *So. Pac. R. R. Co.*, 248 U. S. 409, 412 (1919).

The holding of the Court of Appeals for the Seventh Circuit in *Commissioner* v. *Doyle*, 231 F. 2d 635 (C. A. 7, 1956), upon which decision the decisions in the present cases were predicated, was simply that here there had been clear congressional action to the contrary—"The language of Sec. 23 is clear and unambiguous." 231 F. 2d 635, 636.

On this issue—the meaning of Section 23(a)—the petitioner is silent, except to state that in the Government's view, "the words 'trade or business' as used in Section 23 mean a lawful enterprise and do not cover criminal activities." (Pet. 14.)

It is somewhat unclear whose governmental view this is—since it is certainly not that of Congress nor the Commissioner nor the Tax Court (until the present cases).

Congressional Intent. During consideration of the Revenue Act of 1913, discussion was had in the Senate on the use of the term "trade" in the section of the Act which was the forerunner of Section 23(a). A question was raised about illegal or illegitimate trade and an amendment was offered to add the qualifying words "ordinary and legitimate" before the word "trade". The amendment was rejected. 50 Cong. Rec. 3850.

During the course of the debate on this subject, the purpose of the bill was explained:

> "* * * The object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures and losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horses or upon 'futures', but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way." 50 Cong. Rec. 3849.

In 1934 there first appeared in the Internal Revenue Code the present Section 165 (d), that "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." This was Section 23(h) in the 1939 Code, and Section 23(g) when it first appeared in the Revenue Act of 1934. The House Committee Report on the 1934 Revenue Act stated with reference to the new Section:

> "Existing law does not limit the deduction of losses from gambling transactions where such transactions are legal. Under the interpretation of the courts, illegal gambling losses can only be taken to the extent of the gains on such transactions. *A similar limitation on losses from legalized gambling is provided for in*

> *the bill.* Under the present law many taxpayers take deductions for gambling losses but fail to report their gambling gains. This limitation will force taxpayers to report their gambling gains if they desire to deduct their gambling losses." (Emphasis added.) House Report 704, p. 22, 73d Cong., 2d Sess. (1934).

Since this section was intended to relate to illegal as well as legal gambling, it is clear that the petitioner's statement that Section 23 relates to lawful enterprises only is a view not shared by Congress.

The Congressional intent, if not yet crystal clear, became so with the adoption of the Revenue Act of 1951. It was in this Act that first appeared the 10% excise tax on gross receipts from wagering, Section 3285 Internal Revenue Code of 1951, and the $50 tax and registration requirement for all persons engaged in the business of wagering, Sections 3290 and 3291 of Internal Revenue Code of 1951 (Sections 4401-5, 4411-14, Internal Revenue Code of 1954). These measures were adopted in the wake of the activities of the Special Senate Committee to Investigate Organized Crime in Interstate Commerce, and one of the admitted objects of the 10% excise tax on wagering and the registration requirements was to inhibit the business of gambling. *See United States* v. *Kahriger*, 345 U. S. 22, 27, 35 (1953), upholding the constitutionality of the wagering excise tax.

During the debate on these new sections, Senator Kefauver expressed opposition on the ground that the excise tax and $50 special tax might be construed as a license to violate state law. He offered, in lieu of these provisions, an amendment to Section 23(a). He proposed a new paragraph be added as subsection 23(a)(3) as follows:

> "(3) Illegal Wagering. No deduction shall be allowable under paragraph (1) or (2) to a taxpayer for any expense paid or incurred in or as the result of illegal wagering." 97 Cong. Rec. 12230-31.

The opponents of this amendment argued that it presented serious constitutional difficulties. It was noted that the amendment would convert the tax to one on gross rather than net income. The problem of determining illegality for the purpose of this amendment in the absence of a determination of guilt by the local courts was pointed out, and it was suggested that the inevitable result might well be that the Internal Revenue Service would become a co-operating law enforcement agency with local police. 97 Cong. Rec. 12240.

Senator Kefauver's amendment was defeated. 97 Cong. Rec. 12244.

In their reports on the Revenue Act of 1951 both the House and Senate committees commented on the criticism that the new sections might be construed as a license to carry on illegal activities, and in so doing plainly indicated that there is no distinction, insofar as the federal income tax is concerned between legal and illegal business. Thus both Reports state:

> "Since its inception, the Federal income tax has applied without distinction to income from illegal as well as legal sources, and it has never been generally supposed that such application carried with it any implied authorization to carry on illegal activities. Moreover, in the field of excise taxes the tax on coin-operated gambling devices has been applied without regard to whether or not the operation of a particular machine is in violation of State or local law. The present bill conforms to the pattern and imposes tax without regard to the legality or illegality of the particular wager." House Report No. 586, p. 55; Senate Report No. 781, p. 113, 82d Cong. 1st Sess. (1951).

In addition, the Senate Report made further comment on Senator Kefauver's defeated proposal:

"TAX TREATMENT OF ILLEGAL ACTIVITIES.

Several amendments have been proposed to the Committee which would affect the tax treatment of gamblers and other persons who receive income from illegal sources. In summary, these amendments would—

(a) Disallow as a deduction from gross income any expenses incurred in illegal wagering and any losses resulting from illegal wagering;

* * * * *

Your Committee believes that additional time is necessary for detailed study of these suggestions and therefore believes that action on them should not be taken at this time. The Committee is fully aware of the importance of a strict enforcement of the income tax laws in this area." Senate Report No. 781, p. 120, 82d Cong. 1st Sess. (1951).

Position of Tax Court. This plain and unequivocal meaning of Section 23 has been consistently followed by the Tax Court itself, and until the *Mesi* decision (one of the three decisions for which review is here sought) the Tax Court had rejected any attempts by the Commissioner to disallow rent and salary expenses.

For example, in *G. A. Comeaux*, 10 T. C. 201 (1948), the Commissioner attempted to disallow the ordinary and necessary expenses of an illegal gambling business. The taxpayer operated a "horse-book" establishment in Kansas. For the years 1938 to 1944 the Commissioner denied as deductions sums paid certain persons for protection from arrest and prosecution and salaries paid to persons engaged in operating the business, as well as certain miscellaneous expenses. It was found by the Tax Court that this enterprise was illegal under the criminal statutes of Kansas. The Tax Court affirmed the Commissioner's disallowance for protection payments, but reversed his disallowance of

salary and miscellaneous expenses. In pointing out the distinction, the Tax Court stated, at p. 207:

> "The second issue relates to the deduction of salaries and miscellaneous expenses, the 'legitimate expenses of an illegitimate business'. The amount of such items is not in dispute. These expenses were incurred in earning the income reported by petitioner or attributed to him by respondent. In *Anthony Cornero Stralla*, 9 T. C. 891, at 821, this Court recognized that such expenses are deductible, in contra-distinction to those expenses which are not deductible because contrary to public policy. We said: 'The expenditures here in issue were not made in the actual production of the income; deduction of expenses of that character has been allowed.' The income tax law is not a tax on gross income, even if the income be earned in an illegal business. *Commissioner* v. *Heininger*, 320 U. S. 467. The deduction of such expenses depends on the innate character of the item itself. Thus the protection expenses have been disallowed as being contrary to sound public policy or proscribed types of conduct. But items not so to be characterized may be deductible. The distinction may at first seem nebulous, but it is nonetheless real. The items now under discussion are in the latter category and are allowable deductions. The amounts appear in the findings of facts."

The correctness of the position of the Tax Court was affirmed on review of another aspect of the decision in *Comeaux* v. *Commissioner*, 176 F. 2d 394, 400 (C. A. 10, 1949), where the Court said, in passing:

> "The amounts are not in dispute, and it is agreed that while legitimate expenses incurred in an illegitimate business are deductible, amounts paid for protection are not legitimate business expenses. The Tax Court allowed certain claimed expenses incurred in the operation of the business * * *".

Comeaux is particularly significant to the instant cases since the Kansas criminal statute relating to "horse book"

establishments is identical in its operative language with that of Illinois. Compare Ch. 21, Par. 23-1519 Kan. Gen. Stats. and Ch. 38, Section 336 Ill. Rev. Stats. upon which statute petitioner relies here (Pet. 4). (These statutes are set out in Appendix A to this brief.)

The rather recent shift in the attitude of the Tax Court as indicated by its decisions in the present cases is dramatically pointed up by the fact that in *Commissioner* v. *Doyle*, 231 F. 2d 635 (C. A. 7, 1956), the Court of Appeals *affirmed* the Tax Court which had rejected the petitioner's argument that the rent and salary expenses of an Illinois bookmaker should be disallowed. The *Doyle* decision, upon which the Court of Appeals based its decisions in the present cases, is set out at p. 25 of the Petition.

Even now the Commissioner recognizes that gambling—illegal as well as legal—is a trade or business under Section 23 (a) entitled to deduct its ordinary and necessary expenses. Thus in Revenue Ruling 54-219, Cumulative Bulletin 1954-1, p. 51, petitioner has held that the federal excise tax on wagers and the special tax paid by persons engaged in receiving wagers are deductible as ordinary and necessary expenses under Section 23 (a), and no distinction is drawn between legal and illegal gambling enterprises. This Ruling is set out as Appendix B to this Brief.

The Illinois Statute. Petitioner also suggests that if the taxpayers here were engaged in a "trade or business" within the meaning of Section 23, yet expenses for rent and salary are somehow different than other expenses of a bookmaker in Illinois. This issue is hardly separable from what appears to be petitioner's main thesis that the taxpayers were not engaged in a "trade or business," but here petitioner seems to place some peculiar reliance on the very statute which makes the activity illegal in the first instance.

Since Section 23 (a) specifically permits the deduction of "a reasonable allowance for salaries or other compensation for personal services actually rendered" and "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property" it is irrelevant to respondents' position whether Illinois law specifically makes unlawful the payment of rents and wages in connection with the operation of a bookmaking establishment, itself an unlawful enterprise under Illinois law. However, the fact is that the Illinois statute upon which petitioner relies, Section 336 of the Illinois Criminal Code (Pet. 4; App. A to this Brief) contains no reference to wages or rent. It prohibits the knowing use of premises for the purpose of recording or registering wagers and the recording or registering of wagers. The illegality arises from the *use*, not the payment of wages or rent, and respondents' activities would have been unlawful under the Illinois statute even if the premises had been let rent free, or if their employees had donated their services. Since the business is illegal under this statute, *a fortiori*, all its expenses are illegal—not because any statute declares them to be specifically illegal but because they are incurred in the carrying on of an illegal business. The inevitable logic of petitioner's position would have to be that all expenses of the illegal business would be disallowed and the tax would be on gross income, but this position has been specifically rejected by Congress, as has already been shown in this brief, and rejected by petitioner himself since he allows the deduction of the 10% excise tax and the $50 special tax. (App. B.)

Judicial or Administrative Legislation. What the petitioner seeks here is legislation without benefit of Congress. Commenting on a similar effort when *Commissioner* v. *Heininger*, 320 U. S. 467 (1943) was before the Court of

Appeals, Judge Minton observed that no distinction had been made by Congress or the Bureau of Internal Revenue between income from legal or illegal business. "Both, so far as the statutes and regulations of the Department went, were to be taxed on their net income." He pointed out that although this lack of distinction between legal and illegal business was well known to Congress, no change had been made in the law. (Judge Minton had been a member of Congress when the Revenue Act of 1939 was adopted.) He stated, in his opinion,

> "If this change is to be made and the policy altered, *let Congress do it.* Congress would need only to add the word 'legal' before the word 'trade' in the third line of Section 23 (a)(1).
>
> We are asked, in the guise of construing the words 'ordinary and necessary', to amend the statute. In other words, to engage in a little judicial legislation. We decline the invitation." *Heininger* v. *Commissioner*, 133 F. 2d 567, 570. (Emphasis added.)

The province of petitioner is the enforcement of the federal taxing statute as written by Congress, not the policing of public morals. His efforts here to usurp the legislative functions are similar to those of other administrators.

In *Federal Communications Commission* v. *American Broadcasting Co.*, 347 U. S. 284 (1954), the efforts of the F. C. C. to extend its own powers to accomplish an end which it considered socially desirable were reviewed by the Supreme Court. There the F. C. C. adopted regulations providing for the denial of licenses to radio and television stations broadcasting "give-away" programs. In affirming the judgment of the district court in restraining the enforcement of these regulations, the Court succinctly summarized the issue:

> "It is apparent that these so-called 'give-away' pro-

grams have long been a matter of concern to the Federal Communications Commission; that it believes these programs to be the old lottery evil under a new guise, and that they should be struck down as illegal devices appealing to cupidity and the gambling spirit. It unsuccessfully sought to have the Department of Justice take criminal action against them. Likewise, without success, it urged Congress to amend the law to specifically prohibit them. The Commission now seeks to accomplish the same result through agency regulations. In doing so, the Commission has over-stepped the boundaries of interpretation and hence had exceeded its rule-making power. Regardless of the doubts held by the Commission and others as to the social value of the programs here under consideration, such administrative expansion of § 1304 does not provide the remedy." 347 U. S. 284, 296-97.

CONCLUSION.

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX A.

Illinois Revised Statutes.

Chapter 38, Criminal Code of State of Illinois:

"336. Book-making and pool-selling unlawful.

§ 1. *Be it enacted by the People of the State of Illinois, represented in the General Assembly:* That any person who keeps any room, shed, tenement, tent, booth, or building, or any part thereof, or who occupies any place upon any public or private grounds within this state, with any book, instrument or device for the purpose of recording or registering bets or wagers, or of selling pools, or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, or upon the result of any political nomination, appointment or election, or being the owner, lessee, or occupant of any room, shed, tenement, tent, booth, or building, or part thereof, knowingly permits the same to be used or occupied for any of these purposes, or therein keeps, exhibits or employs any device or apparatus for the purpose of recording or registering such bets or wagers, or selling of such pools, or becomes the custodian or depository for hire or privilege, of any money, property, or thing of value staked, wagered or pledged upon any such result, shall be punishable by imprisonment in the county jail for a period not longer than one year, or by fine not exceeding $2,000 or both. Provided, however, that the provisions of this act shall not apply to the actual enclosure of fair or race track associations that

are incorporated under the laws of this state, during the actual time of the meetings of said associations, or within twenty-four hours before any such meetings."

Kansas General Statutes:

"Ch. 21, Par. 21-1519.

"*Bookmaking or selling pools, or permitting on premises; penalty.* That any person who keeps any room, shed, tenement, booth or building, or any part thereof, or who occupies any place upon any public or private grounds within this state with any book, instrument or device for the purpose of recording or registering bets or wagers or selling pools, upon the result of any trial or contest of skill, speed or power of endurance of man or beast which is to be made to take place within or beyond the limits of this state, except within the inclosure of a race track and upon races or trials of speed being conducted within said inclosure (provided that the exception herein shall not apply to any race track or inclosure for more than two weeks in any one year), or any person who records or registers bets or wagers, or sells pools upon the result of any trial or contest of skill, speed or power of endurance of man or beast, which is to be made or take place within or beyond this state; or upon the results of any political nomination, appointment or election which is to be made or held either within or beyond the limits of this state, or being the owner, lessee or occupant of any room, shed, tenement, booth or building, or part thereof, knowingly permits the same to be used or occupied for any of the purposes hereinbefore prohibited, or therein keeps, exhibits or employs any device or apparatus for the purpose of registering such bets or wagers, or selling pools, as are hereinbefore prohibited, or becomes the custodian

or depositary for hire or privilege of any money, property or thing of value which is staked, wagered or pledged contrary to the provisions of this act, shall be guilty of a misdemeanor, and on conviction shall be punished by imprisonment in the county jail for a period of one year and by a fine of one thousand dollars."

APPENDIX B.

Revenue Ruling 54-219, Internal Revenue Cumulative Bulletin 1954-1, page 51.

"Regulations 118, Section 39.23(a)-1: Rev. Rul. 54-219 Business Expenses.

"The Federal excise tax on wagers under section 3285(d) of the Internal Revenue Code and the special tax under section 3209 of the Code paid by persons engaged in receiving wagers are deductible, for Federal income tax purposes, as ordinary and necessary business expenses under section 23(a) of the Internal Revenue Code, provided the taxpayer is engaged in the business of accepting wagers or conducting wagering pools or lotteries, or is engaged in receiving wagers for or on behalf of any person liable for the tax under section 3285(d) of the Code."